2006

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Public Administration Review, May - June 2006.
http://hdl.handle.net/10945/43707

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Two recent examinations of management practices in three federal departments provide contemporary evidence of the need to incorporate procedures like those of the Sarbanes-Oxley Act in the public sector. Although each department established what appeared to be well-designed internal controls, all lacked sufficient monitoring and assessment of the efficacy of those controls. By requiring senior management to attest to the strength of their control mechanisms, as required by the newly revised OMB Circular A-123, the quality of this monitoring should improve. Findings from a recent study of private-sector implementation of these reforms are described, along with suggestions for public administration research and practice at all levels of government.

Public documents discussed:

- Primary: Revisions to OMB Circular A-123, "Management's Responsibility for Internal Controls," issued December 21, 2004, effective October 1, 2005.
- Secondary: U.S. Government Accountability Office, "Managerial Cost Accounting Practices: Leadership and Internal Controls are Key to Successful Implementation" (GAO-05-1013R) and "Defense Management: DOD Needs to Demonstrate that Performance-Based Logistics Contracts are Achieving Expected Benefits" (GAO-05-966)

It is not enough for agencies to have internal controls over their critical processes; the new standard for federal agencies under OMB (Office of Management and Budget) Circular A-123 (2004) is to ensure that those controls are effective. Recent audits by the Government Accountability Office (GAO) provide some insight into how well the federal government is controlling its internal controls. Likewise, a recent assessment of publicly traded firms provides helpful insights for public managers.

Internal controls are defined by the American Institute of Certified Public Accountants, in its Statement of Auditing Standards No. 55, as the policies and procedures promulgated by management to provide reasonable assurance that specific entity objectives will be achieved (American Institute of Certified Public Accountants, 1988). The GAO uses a similar definition: "An integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations" (GAO 1999).

The revised OMB Circular A-123 took effect at the beginning of the 2006 federal fiscal year on October 1, 2005. This revision incorporated an essential requirement of the Sarbanes-Oxley Act, which was enacted in 2002 in response to scandals among publicly traded corporations. Section 404 of the act requires auditors of companies to include in their annual reports an assessment of internal controls that (1) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contains an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Similarly, a fundamental purpose of the revision to OMB Circular A-123 was to "emphasize management's responsibility for assessing and documenting internal control over financial reporting" (Bolton 2004). Financial reporting is broadly defined to include not only the financial statements required under the Chief Financial Officers Act but also any "reports that could have a material effect on a significant spending, budgetary or other financial decision" at multiple levels of the organization (Bolton 2004). Management must be able to document the assessment process and methodology used to support its assertion about the effectiveness of the internal controls. Incorporating the broadest interpretation, not only is management responsible for implementing internal controls to provide reasonable assurance the agency meets its intended objectives, it is also responsible for self-assessing, correcting, and reporting on the efficacy of those controls. In short, controlling the internal controls is the new standard.

The revision of OMB Circular A-123 provides the framework for those tasks. It not only states the objectives of internal control, it also defines management's responsibility to develop and maintain control activities that comply with five standards: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. The circular integrates the related legislative and regulatory requirements and issues guidance on assessing, correcting, and reporting on internal controls.

Recently, the GAO issued two reports that provide some insight into how well the federal government is doing on this front. Although these reports do not directly address agencies' reporting on the efficacy of their controls, by serving as examples of the practice of controlling controls, they provide a preview of federal government activity in this area.

In the first report, the GAO reviewed the federal Departments of Labor and Veterans Affairs (VA) to determine how cost-accounting information is generated and how that information is used to support managerial decision making and provide accountability (GAO 2005b). According to the GAO report, such accounting "involves the accumulation and analysis of financial and non-financial data, resulting in the allocation of costs to organizational pursuits such as performance goals, programs, activities, and outputs." Clearly, then, management cost accounting itself is an internal control device.

One sees in the report that although the two departments employ different strategies to implement cost-accounting systems, both (plan to) use cost-accounting data for budgetary and resource-allocation decisions. What the GAO found is that controls on cost-accounting practices should be strengthened in both departments. The VA, by policy and by design, does not direct managerial cost activities at the departmental level; it delegates that responsibility to the heads of the three subordinate agencies. Those agencies, in turn, supply cost information for department-wide reporting.

Though the financial data feeding the cost-accounting systems is sound, the GAO had concerns about the reliability of the nonfinancial data in the cost-accounting system used by the Veterans Health Administration (VHA), evidenced by prior audits and inspector general findings. Nonfinancial data are crucial to the decision-support information provided by managerial cost-accounting systems; unreliability could skew management decision making. The VHA noted that it had disseminated audit guides for nonfinancial data to its agencies, but the GAO stated that although promulgation of policy is a critical step, there was insufficient documentation that the audits were conducted, and the risk of inaccurate data remains.

The Department of Labor implemented a new managerial cost-accounting system in September 2004. Its strategy was to employ a commercial software tool at the departmental level and to have each subordinate agency fashion models using the tool. The system integrates performance and financial data, benchmarks performance, provides trend analysis, and allows for sensitivity analysis. Policies and procedures are being updated and training conducted, and refinements are planned. The implementation plans are laudable, but again, the GAO cited the department's lack of postimplementation review as a weakness. The GAO also applauded the quality of the financial data audits but also found weakness in the reliability of controls over nonfinancial data, as in the VA findings.

In the second GAO report, performance-based logistics contracts in the U.S. Department of Defense were assessed to determine whether they are achieving their expected benefits (GAO 2005a). Since the late 1990s, Defense Department leadership has increasingly advocated the use of performance-based contracts for weapons system logistics support. The 2001 Quadrennial Defense Review validated the approach on the grounds performance-based contracts lead to compressed supply chains, streamlined processes, reduced inventory levels, and reduced cost while improving readiness. Again, if we define internal controls as the policies and procedures effected by management to provide reasonable assurance that specific entity objectives will be achieved, performance-based contracts serve as a mechanism for control.

The GAO assessed 15 performance-based logistics programs from a list provided by the Defense Department of those it considered successful. To ensure the effectiveness of the arrangements, the department issued guidance to the services that recommended a business-case analysis be prepared before adopting a performance-based logistics approach in order to justify the decision and to establish cost and performance goals. Furthermore, the guidance recommended that program offices update the analysis at appropriate decision points after implementation to validate assumptions and assess actual performance and costs. These ex poste analyses were to use data from the monitoring strategy for the performance-based contract.

The GAO found that only one of the 15 programs actually completed an ex poste business-case analysis consistent with the guidance. According to the report, "In general, program offices had not updated their business case analysis . . . because they assumed that the costs for weapon system maintenance incurred under a fixed-price, performance-based logistics contract would always be lower . . . and because they lacked reliable cost and performance data needed to validate assumptions" (GAO 2005a). Senior Defense

Department leadership had not established procedures to monitor compliance with the guidance.

These two GAO examinations of management practices in three federal departments provide contemporary evidence of the need to incorporate procedures like those of the Sarbanes-Oxley Act in the public sector. Although each department established what appeared to be well-designed internal controls, all lacked sufficient monitoring and assessment of the efficacy of those controls. By requiring senior management to attest to the strength of their controls, the quality of the monitoring should improve.

These rules are now being applied in the public sector, just a few years after they were applied in the commercial sector. Since the passage of the Sarbanes-Oxley Act in 2002, publicly traded firms have been required to make such attestations. In the first survey of the state of affairs among publicly traded firms, Ge and McVay (2005) sampled 261 companies that disclosed weaknesses in their internal controls. They found that "inadequate accounting resources underpin the majority of internal control weaknesses." Complex firms were more likely to have material weaknesses in their controls than relatively simple ones. The most frequently cited problem was employee training. In order of decreasing frequency, specific issues included period-end accounting procedures and revenue recognition—weak controls in these areas increase the risk of misstating crucial performance information (earnings)—account reconciliation, and segregation of duties.

Ge and McVay's findings are consistent with the two recent (and many prior) GAO audits described here. Whether the employees who implemented the designed controls were using them effectively was a consistent theme of the GAO audits. Although revenue recognition does not have the same import in the public sector, solid internal control programs should target the most significant areas, whatever they are, and the Defense Department audit clearly cited a weakness in a significant area. Likewise, period-end accounting procedures and account reconciliation were both cited in the cost-accounting audits of the VA and Labor Departments. Government managers and executives would do well to learn from the four-year head start that publicly traded companies have had in this area.

What are the implications for public administration? A repeat of the Ge and McVay study among federal agencies should reveal important information for public managers. Readers of *PAR* are reminded of an article written last year by George Boyne and colleagues on self-evaluating organizations (Boyne et al. 2004). These GAO audits highlight the need for introspection to properly control internal controls. The six variables in that Boyne et al. cite are similar to the internal control standards identified by the OMB. Future researchers may replicate Boyne using the OMB standards as variables.

Those whose interests lie outside the federal government should note that the OMB's standards are identical to those used by COSO, the Committee of Sponsoring Organizations of the Treadway Commission.[1] The OMB does not fail to cite the importance of control and security over information technology, similar to the open-source COBIT standards promulgated by the Information Systems Audit and Control Association.[2] Further, Appendix A to OMB Circular A-123 contains an implementation guide that practitioners at any level of government will find helpful in controlling their internal controls.

Notes

1. See www.coso.org.
2. COBIT is an acronym for Control Objectives for Information and Related Technology; see www.iasaca.org.

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